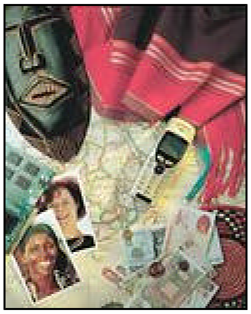

FINANCE & DEVELOPMENT
A quarterly magazine of the IMF
December 2001, Volume 38, Number 4

The Role of Institutional Reforms

Seyni N'Diaye

Globalization began gaining momentum in the 1960s when businesses in search of larger markets expanded their reach and interests beyond national borders. Four major developments have defined and strengthened this process:

- the expansion of the universe of economic activity beyond the nation-state;
- the liberalization of international trade;
- the growing importance of international financial flows; and
- the growth of information and communication technologies.

These developments have almost completely refashioned the world economic system.

However, while opening up new prospects for economic growth on a global scale, the new world economy presents daunting challenges for sub-Saharan African countries. Indeed, with less than a 2 percent share of world trade, modest direct investment flows, worsening poverty, and conflicts breaking out in many parts of the continent, sub-Saharan Africa is confined to the peripheries of globalization. These challenges must obviously be met with rigorous action, notably structural and institutional reforms, to allow the region to take full advantage of the benefits of globalization while minimizing the risks. Creating an economic environment that fosters the growth and expansion of efficient enterprises calls for a redefinition of the role and functions of the state, civil society, the private sector, and regional organizations.

Redefining the role of the state

Until recently, the state's scope of activities had no defined limits. In addition to its sovereign functions (for example, security, justice, education, and health care), it was involved in economic life through direct control over the production and distribution of many goods and services. In a number of countries, the state was also responsible for managing financial institutions, as well as controlling trade and capital flows between the national economy and the rest of the world.

This interventionist system, which was justified in various ways, eventually ran out of steam. But it did not give way to a burgeoning private initiative. A restrictive regulatory framework limited private initiatives to marginal activities, stifling the emergence of a true entrepreneurial class. Moreover, the rare foreign capital that has flowed into the region has been contingent on investors being granted monopoly rights and protection from competition.

It is precisely from this restrictive regulatory framework that African countries must extricate themselves if they are to realize their true potential in the global economy. For this to happen, government action must focus on four areas.

Stabilizing the macroeconomic situation. This is essential if African countries are to be competitive in the globalized economy. High inflation rates, unproductive spending, fiscal imbalances, and large balance of payments deficits need to be contained. Only then will the state be able to devote more resources to the construction of adequate infrastructure (such as roads, ports and airports, electricity, and water), consolidation of the long-term bases of development (such as education, health care, and the environment), and the struggle against poverty and exclusion.

Reducing the size of the public sector. The state needs to withdraw from the commercial sector and devote more time and resources to the delivery of essential public services. The tool for this is the privatization of inefficient public enterprises. The private sector is far better equipped than the government to manage commercial activities effectively, because its decision-making apparatus is less unwieldy and its ability to adapt to changes in the environment is greater.

Reforms in this area must be guided by the desire to liberalize economic activities and promote free enterprise. Therefore, the state must encourage healthy competition among businesses while eliminating economic rents and mechanisms that legally confer a dominant position on a firm or economic agent.

A framework for allowing market forces to determine prices needs to be instituted. Such a framework would encourage competition among businesses and suppress the distortions inherent in any system of administered prices and controls. On the external front, the state needs to liberalize trade and foreign exchange transactions to attract foreign investment.

Good governance. Countries need to focus on the following issues:

- *Transparency of government.* Citizens must be kept informed of the decisions of the state and their justification.
- *Simplicity of procedures.* Whether in fiscal matters, investment, or other areas, administrative procedures need to be as simple as possible, with the number of participants reduced to a minimum.
- *Responsibility.* Public officials must be held accountable and, if necessary, penalized for offenses.
- *Fight against corruption.* Eradication of this scourge is imperative for promoting healthy competition, eliminating surcharges, and strengthening the efficiency of economic management.
- *Individual freedom and collective expression.* A free and responsible press, in particular, is an important pillar of democracy.
- *Independence of the legal system.* The legal system must be free from pressure and intervention from political forces or any other organization, to ensure that its decisions are independent and impartial.

Role of civil society

African civil society has grown remarkably in recent years. It is becoming more organized and collaborates effectively with civil society in other countries. Cooperation with institutions such as the International Federation of Human Rights is a good example of how this phenomenon works. In many African countries, civil society plays a dual role. First, as a mouthpiece for democracy, it is the chief challenger of the power of the state, limiting deviations from good governance and acting as a regulator in the political arena. In Senegal, for example, civil society is increasingly visible as a credible negotiator between the people and public powers.

Second, despite its overall efficiency, the market economy can generate negative social and environmental externalities. Civil society, as represented by consumer associations and nongovernmental organizations, serves as a watchdog to contain market excesses and to guard against environmental abuse by increasing public awareness of ecological problems—for example, disposal of toxic waste.

Civil society also has a major role to play in smoothing the entry of African countries into the global economy. Being close to the people and their concerns, it is the appropriate forum for raising awareness of the challenges globalization poses and for the necessary changes in thinking. It is therefore important that civil society be fully involved in defining growth strategies, whose success is largely dependent on popular support.

Finally, civil society can also play a significant role in promoting the mobilization of savings through decentralized financial institutions and, in general, helping to combat poverty.

The private sector

In the context of globalization, the private sector is the main engine for growth. Accordingly, its operations must be free of heavy-handed and cumbersome regulatory or bureaucratic procedures that could slow its expansion.

To take full advantage of the opportunities globalization offers, the private sector needs high-quality human resources and managerial capabilities. The sector itself must assume some responsibility for the education and training of the workforce, enabling workers to take advantage of the potential offered by new information and communication technologies and to benefit from the relocation of industrial businesses and services.

To flourish, however, the private sector also needs to be supported by a sound banking and financial sector within a liberalized institutional context. In particular, credit policy must be managed flexibly and be resolutely oriented toward fighting inflation. Exchange and interest rates must also be as realistic as possible, reflecting internal cyclical variations while staying connected to international market conditions.

In sub-Saharan Africa, perhaps more than elsewhere, the success of a credible monetary policy depends crucially on a central bank that is wholly independent of political pressure. In addition, because of their significant role in the collection of savings and the financing of economic activity, banks' operations need to be supported by a secure regulatory framework that meets three criteria:

- freedom of action that excludes any intervention by political powers in the distribution of credit;
- development of and compliance with prudential standards comparable to those used internationally; and
- establishment of a banking oversight committee specifically responsible for monitoring strict compliance with approved banking management methods.

The financial market plays another lead role in the global economy. Any country wishing to be part of this economy must have a solid and credible financial sector, capable of tapping savings and offering businesses the possibility of diversifying their portfolios.

The development of microfinance is another important aspect of the private sector's role. In addition to financing micro businesses and small and medium-sized enterprises that do not have access to the traditional financial sector, decentralized financial institutions are a powerful engine for growth and employment as well as a vehicle for social integration. They are an important tool in combating the impoverishment of people who might otherwise be excluded from the beneficial effects of globalization while suffering its negative effects. Therefore, the microfinance sector must be consolidated and better organized to engage the maximum number of economic agents and contribute to the expansion of markets. To establish its effectiveness and credibility, the microfinance sector, like the banking system, will need to be monitored by adequately equipped control structures.

Regional integration

As evidenced by the formation in the past several years of regional groupings of countries (such as the North American Free Trade Agreement; Mercosur [Common Market of the South, which comprises Argentina, Bolivia, Brazil, Chile, Paraguay, and Uruguay]; and the Association of South East Asian Nations), regional integration is not incompatible with globalization. In fact, the setting up of regional economic areas in which countries—for historical, geographical, cultural, economic, or political reasons—try to create an area of stability, growth, or solidarity has often been instrumental in easing the path toward full global integration. For African countries, which are individually handicapped by small markets, weak basic infrastructure, and insufficient financial and human resources, regional integration can actually speed up globalization. The benefits of regional integration include opportunities for economies of scale and streamlined production processes that will make businesses internationally competitive. Other beneficial aspects of regional integration—such as the harmonization of rules and procedures, free circulation of goods, people, and capital, and the elimination of customs barriers—can create a business environment that attracts and encourages private sector activity.

Achieving this integration calls for a real political desire to unify national economic areas. It also requires the establishment of and compliance with economic and financial convergence criteria and the harmonization of the legal and regulatory frameworks governing economic activities. But reaching this goal also entails the creation of strong community entities equipped with the necessary powers and means to induce all countries in the economic community to respect the established standards. These entities must be credible and have enough financial resources to assume responsibility for community projects, especially in infrastructure, human resource development, and poverty reduction.

It is encouraging that steps toward regional integration have been taken with the New African Initiative adopted by African heads of state earlier in the year.

Conclusion

Handicapped by the weakness of its infrastructure, lack of qualified human resources, and low level of industrial development, sub-Saharan Africa is clearly not sufficiently integrated into the global economy. However, it is also clear that the region cannot afford to remain on the sidelines of globalization for much longer. To facilitate its inclusion in the world economy, Africa must begin to make significant institutional reforms—in particular, by refocusing the functions of the state toward its essential mission of delivering needed public services; promoting the development of a dynamic private sector within a liberalized and transparent framework; and strengthening the role of civil society, which is critical for any social and economic change. Regional economic integration is also a necessary element for securing Africa's active participation in globalization.

All these reforms have extremely high financial and social costs that far exceed the continent's current resources. It is hoped, therefore, that Africa may be able to count on international cooperation to support its economic development efforts. Particular attention must be paid to managing the external debt that weighs heavily on public finances and considerably reduces the maneuvering room governments need to generate financing for infrastructure and poverty reduction. The various debt-reduction initiatives undertaken by the international financial community are very encouraging and should be explored more intensively.

Africa also has an enormous need for new financial resources to revive investment, and it is hoped that Africa's partners can help orient more direct foreign investment to the continent, using the appropriate incentives (guaranteed investments, lines of credit, and so on).

Financial aid from international agencies tends to be subject to numerous conditions, and disbursement procedures are often unwieldy. Flexibility in the delivery of aid and financing might help speed its disbursement.

Finally, Africa must also be able to count on the technical assistance of its external partners to strengthen its human resource capabilities. In this regard, particular emphasis should be placed on training in the use of new information and communication technologies.

Seyni N'Diaye is National Director for Senegal of the Central Bank of West African States (BCEAO).